

DISMISSAL OF CHAPTER 7 CASES UNDER 11 U.S.C. § 707

AS AMENDED BY
*THE BANKRUPTCY ABUSE PREVENTION
AND CONSUMER PROTECTION ACT OF 2005*

WHAT DOES THE “MEANS TEST” MEAN?

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I. Section 707 History and Application

Under the *Bankruptcy Reform Act of 1978*, a chapter 7 case could be dismissed under section 707 for cause including three enumerated but nonexclusive reasons: 1) unreasonable delay by the debtor causing prejudice to creditors, 2) failure to pay the requisite filing fees, and 3) failure to file timely schedules.

The *Bankruptcy Amendments Act of 1984* retained these grounds for dismissal but redesignated them as subsection (a). The act added subsection (b) to permit dismissal of a chapter 7 case filed by an individual with primarily consumer debts if granting bankruptcy relief would constitute a “substantial abuse” of the provisions of chapter 7. Dismissal under new subsection (b), however, could only be effected by the court *sua sponte* and not at the request or suggestion of any party.

Finally, the *Bankruptcy Act of 1986* accorded standing to the United States trustee/bankruptcy administrator to bring substantial abuse motions as follows:

- (a) The court may dismiss a case under this chapter only after notice and a hearing and only for cause, including—
 - (1) unreasonable delay by the debtor that is prejudicial to creditors;
 - (2) nonpayment of any fees and charges required under chapter 123 of title 28 [28 USC §§ 1911 et seq.]; and
 - (3) failure of the debtor in a voluntary case to file, within fifteen days or such additional time as the court may allow after the filing of the petition commencing such case, the information required by paragraph (1) of section 521, but only on a motion by the United States trustee.

(b) After notice and a hearing, the court, on its own motion or on a motion by the United States trustee, but not at the request or suggestion of any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts if it finds that the granting of relief would be a substantial abuse of the provisions of this chapter. There shall be a presumption in favor of granting the relief requested by the debtor. . . .

11 U.S.C. § 707.

The phrase “substantial abuse” is not defined by the statute. Neither is it clear from the context how the phrase should be construed. Not surprisingly, courts have reached differing interpretations.

Some circuits hold that a debtor’s ability to repay creditors is sufficient, without more, to constitute “substantial abuse.” *United States Trustee v. Harris*, 960 F.2d 74 (8th Cir. 1992); *Zolg v. Kelly (In re Kelly)*, 841 F.2d 908 (9th Cir 1988). But even in circuits adopting this *per se* rule, the standards for determining “ability to repay” vary from court to court.

Other circuits consider factors in addition to the debtor’s ability to repay under a “totality of the circumstances” test. The factors include: 1) has the debtor been stricken by a sudden calamity, 2) did the debtor incur cash advances or consumer purchases far in excess of ability to repay, 3) is the debtor’s budget excessive and unreasonable, 4) are the schedules accurate, and 5) was the petition filed in good faith? *Green v. Staples (In re Green)*, 934 F.2d 568 (4th Cir. 1991); *Stewart v. United States Trustee (In re Stewart)*, 175 F.3d 796 (10th Cir. 1999).

II. Congressional Intent Under the BAPCPA (Bankruptcy Abuse Prevention and Consumer Protection Act of 2005)

BAPCPA makes sweeping changes to 11 U.S.C. § 707(b). Though Congressional intent will certainly be the subject of much debate, it appears clear in at least a few respects.

First, a debtor's ability to repay unsecured creditors (in a designated amount and over a specified term), standing alone, is sufficient to constitute abuse. Therefore, the new law both codifies and quantifies the *per se* rule expressed by *Harris* and *Kelly*. See 11 U.S.C. § 707(b)(2).

Second, in considering ability to repay, a debtor's expenses are limited to those within his/her means. Therefore, debtors making improvident lifestyle choices will find their expenses limited to a reasonable level as expressed by the Internal Revenue Service expense templates.

Third, Congress broadens the parties with standing to file motions to dismiss for abuse under § 707(b). With certain exceptions, any party in interest may now file such a motion.

Finally, Congress shifts the presumption of abuse from one in favor of the debtor to one against any debtor failing the means test. The debtor may overcome the presumption of abuse only by demonstrating unavoidable, special circumstances justifying either the reduction of income or an increase in expenses. See § 707(b)(2)(B).

III. The Basic Means Test Formula

The means test has two parts. The first hurdle of the means test is to compare the debtor's annual income ("current monthly income" x 12) to the median income for an Alabama household of the same number of people.¹

If the annual income of both the debtor and the debtor's spouse is less than the State median income, then the debtor passes the means test, and the inquiry stops.² Why? Because no one, including the court *sua sponte*, has standing to file a motion to dismiss under the

¹ "Current monthly income" is defined at 11 U.S.C. § 101(10A) and will be discussed *infra*. Alabama median income based on family size is currently:

1-earner	\$32,762
2-person household	39,755
3-person household	48,957
4-person household	54,338

Source: <http://www.census.gov/hhes/www/income/statemedfaminc.html>.

If the debtor's household exceeds 4 individuals, the median income is calculated by adding \$525 per month to the highest median income for a family of 4 or fewer individuals for each individual in excess of four. Therefore, in Alabama the median income for a 5-person household is \$60,638 (\$54,338 + \$6,300 (\$525 x 12)).

Median Family Income is a term defined by the Code at § 101(39A) as that determined by the Bureau of the Census.

² A nondebtor spouse's income is excluded from the calculation only if the parties are separated. See § 707(b)(7)(B) for the specifics of this exception.

means test in that circumstance.³ See § 707(b)(7)(A).

If the annual income of both the debtor and the debtor's spouse is greater than the State median income, then part two of the means test is implicated. Part two involves the reduction of the debtor's current monthly income by allowed expenses to arrive at a bottom-line calculation of the debtor's ability to repay his debts over a five-year term.

If the debtor's currently monthly income less allowed monthly expenses multiplied by 60 (months) is at least \$10,000, abuse is presumed. If the amount is between \$6,000 and \$10,000, abuse is presumed if the amount would be sufficient to pay 25% of general unsecured claims.

Written in the form of a mathematical equation, part two of the means test results in a presumption of abuse if:

$$(\text{current monthly income} - \text{allowed monthly expenses}) \times 60 \geq \$10,000$$

OR

$$(\text{current monthly income} - \text{allowed monthly expenses}) \times 60 \geq \$6,000 \text{ if}$$

such amount is 25% or more of the unsecured debts.

The task, then, is to determine the debtor's current monthly income and allowed monthly expenses.

³ There is yet another safe harbor from the application of the means test of § 707(b)(2). The means test does not apply to a disabled veteran whose debts were incurred primarily during a period of active duty or of performing homeland defense. See § 707(b)(2)(D).

A. Current Monthly Income

New subsection 10A of § 101 defines “current monthly income” as the average monthly income received by the debtor from all sources during the six calendar months preceding the filing.⁴

“Current monthly income” includes amounts regularly paid by other entities to defray the debtor’s household expenses. Therefore, child support receipts are included as income without reference to their treatment by the Internal Revenue Code.

“Current monthly income” does not include payments received under the Social Security Act, payments to victims of war crimes or crimes against humanity, or payments to terrorism victims.

The debtor’s current monthly income is no longer a snapshot of income on the date of the commencement of the case. Because it is an average of the debtor’s income over the previous six calendar months, interesting anomalies may occur. For example, debtors who experience a dramatic reduction of income immediately prior to filing may fail the means test because their higher income is included in the calculation. In such instances the debtors would be required to show “special circumstances,” like the loss of the higher paying job, to rebut the presumption of abuse.⁵

⁴ The six-month period ends on the last day of the calendar month preceding the filing.

⁵ Section 707(b)(2)(B)(i) requires the debtor to show “special circumstances” justifying a reduction of income or additional expenses in order to rebut the presumption of abuse.

B. Allowed Monthly Expenses

Subsections 707(b)(1) and 707(b)(2)(A)(ii) through (iv) describe the allowable expenses that may be used to reduce a debtor's current monthly income. Charitable contributions are allowable within the parameters of § 548(d). 11 U.S.C. § 707(b)(1).

Section § 707(b)(2)(A)(ii) references certain standards issued by the Internal Revenue Services which are used to determine the next group of deductible expenses. Three specific standards are referenced; 1) the National Standard, 2) the Local Standard, and 3) Other Necessary Expenses.

1. The National Standard

This standard covers five specific categories of expenses: 1) food, 2) housekeeping supplies, 3) apparel and apparel related services, 4) personal care products and services, and 5) miscellaneous.

The amount of the allowance under this standard is determined by income and household size. *See* Attachment 1, Item 1 (total allowance) and Attachment 2 (subtotals for each category).

The National Standard functions as an allowance and may be claimed in full by the debtors even though their actual expenses are less than the Standard. However, the opposite is not true. The Standard serves as a cap restricting the debtor's allowable expenses to the Standard amount.⁶

⁶ There is one exception: if the debtor demonstrates that it is reasonable and necessary, the allowances for food and clothing may be adjusted by up to 5% if the debtor's

2. The Local Standard

This Standard applies to only two categories of expenses: 1) housing/utilities and 2) transportation.

The housing/utility allowance is determined by household size for a specific county. *See* Attachment 1, Item 2 (selected counties); Attachment 3 (all Alabama counties).

The housing/utility allowance is treated as an allowance in the sense that it can be fully claimed by debtors whose actual housing/utility costs are less than the allowance. On the other hand, the allowance serves as an expense cap in the sense that a debtor whose actual housing/utility costs are greater than the allowed amount cannot claim the greater sum.⁷

The transportation allowance under the Standard is itself divided into two categories. The first is an allowance for ownership costs. This is a nationwide allowance and is currently \$475 for the first vehicle and \$338 for the second. *See* Attachment 1, Item 3 and Attachment 4.

The second is an allowance for operating costs/public transportation. This allowance is regionally based. Alabama falls within the South Region. *See* Attachment 1, Item 3 and Attachment 4.

actual expenses for these categories exceed the Standard. *See infra*.

⁷ There is one exception: if the debtor demonstrates that it is reasonable and necessary and provides documentation of actual expenses for home energy costs, the allowance for housing and utilities may be adjusted upward to reflect actual home energy costs. *See infra*.

As with the housing/utility allowance, the transportation allowance may be claimed in full even if the debtor's actual expenses are less than the allowance. To the extent the debtor's actual transportation expense is greater than the allowance, the allowance similarly serves as a cap.

Finally, both the housing/utility and transportation allowances must be reduced by amounts paid to secured creditors for these expenses. The allowances cannot be reduced beyond zero. The reduction is necessary to prevent duplication (double dipping) in that payments made to secured creditors are separately deducted from current monthly income.

3. Other Necessary Expenses

The Internal Revenue Service has recognized that taxpayers may have expenses outside the National and Local Standards. However, the Service has not issued any standards governing additional categories or published an exhaustive list of the types of expenses allowable.

The Service's test for the allowance of an expense under this "other" category is to determine whether the expense is to provide for the health and welfare of the debtor or his family or is for the production of income. While it is not entirely clear what types of expenses may be included within this category, the following eight general types of expenses have emerged and been recognized by the Internal Revenue Service in its dealings with delinquent taxpayers: 1) current taxes, 2) involuntary wage deductions, 3) insurance, 4) court-ordered payments, 5) childcare costs, 6) health care costs, 7) cellular phone costs, and 8) business expenses.

11 U.S.C. § 707(b)(2)(A)(ii) authorizes the debtor to deduct the actual costs of expenses within the “Other Necessary Expenses” category.

4. Allowable Expenses Beyond Other Necessary Expenses

One would expect that the Other Necessary Expense category under the IRS standards would cover all other allowable expenses. It does not. Congress has listed a number of specific, additional expenses in 11 U.S.C. § 707(b)(2)(A)(ii)(I) through (V) that may be deducted from the debtor’s current monthly income. These expenses, the first three of which are found in § 707(b)(2)(A)(ii)(I), are as follows:

1) reasonably necessary expenses for health insurance, disability insurance, and health savings accounts for the debtor and the spouse or dependents of the debtor.

2) reasonably necessary expenses incurred to maintain the safety of the debtor and the debtor’s family from family violence. Note that these expenses shall be kept confidential by the court.

3) an additional allowance of up to 5% of the food and clothing allowance for reasonable and necessary food and clothing expenses exceeding the allowance under the National Standard.

4) reasonable and necessary expenses for the care and support of an elderly, chronically ill, or disabled member of the debtor’s household or family (within a designated degree) that is unable to pay for these expenses. Section 707(b)(2)(A)(ii)(II).

5) projected chapter 13 trustee compensation and expense not to exceed 10% of plan payments. Section 707(b)(2)(A)(ii)(III).

6) actual expenses of no more than \$1,500 per child for costs of attending primary or secondary school. Note that the debtor is required to both document and justify this expense. Section 707(b)(2)(A)(ii)(IV).

7) an additional allowance for actual home energy costs exceeding the Local Standard for housing/utilities. The debtor is required to document this expense and demonstrate that it is both reasonable and necessary.

A problem arises in that the Local Standard does not subdivide the allowance for housing/utilities. Therefore, how does one calculate the amount by which actual home energy costs exceed the standard? Section 707(b)(2)(A)(ii)(V).

5. Deductions for Secured and Priority Debt Payments

In order to arrive at the amount available to pay unsecured creditors in a hypothetical chapter 13 case, deductions must be made for payments to secured and priority creditors.

Under § 707(b)(2)(A)(iii), payments to secured creditors are deducted from current monthly income. This amount is calculated by totaling all payments due to secured creditors over the 60 months following the petition and dividing that total by 60 for the monthly average. The amount necessary to cure defaults in payments to secured creditors may also be included in the total if it relates to the debtor's home, car, or property essential to the debtor's support.

In much the same manner payments that would be made to priority creditors under a chapter 13 plan may be averaged and deducted from the debtor's current monthly income. Section 707(b)(2)(A)(iv).

IV. Dismissal for Abuse Other Than Through the Means Test

A motion to dismiss for abuse may be predicated on the presumption that arises against any debtor failing the means test. The means test is based solely on a calculation of the debtor's ability to repay his debts over a five-year term. However, if the presumption of abuse either does not arise in a case or is rebutted by a showing of "special circumstances," may a motion to dismiss for abuse be predicated on other grounds? Yes.

Under § 707(b)(3), a case may be dismissed if it was filed in bad faith or if the totality of the debtor's financial circumstances demonstrate abuse. Therefore, a debtor's failure to pass the means test is but one method of establishing abuse under § 707(b)(1).

All parties in interest enjoy standing to file motions under § 707(b)(3) if the debtor's annualized current monthly income is over the State median income for a household of the same size. However, if the debtor's income is below the median, only the court *sua sponte* and the bankruptcy administrator have standing to file such motions.

Finally, if the victim of a crime of violence or drug trafficking crime (as defined by title 18) moves to dismiss the chapter 7 case of the individual convicted of the crime, the court may dismiss the case if it is in the best interest of the victim. However, the case may not be dismissed if the debtor proves that the bankruptcy case is necessary to satisfy a claim for a domestic support obligation. Section 707(c).

V. Liability of Debtor's Counsel

If the trustee prevails on a motion under 11 U.S.C. § 707(b), a debtor's attorney found to have violated Fed. R. Bankr. Proc. 9011 (in filing the case under chapter 7) may be ordered to reimburse the trustee for all reasonable costs (including attorney fees). In addition, the attorney may be ordered to pay a civil penalty to the trustee or bankruptcy administrator. Section 707(b)(4).

VI. Liability of Creditor or Creditor's Counsel

The court may award the debtor reasonable costs (including attorney fees) for successfully defending a motion brought under § 707. Such costs may not be imposed against the trustee, the bankruptcy administrator, or a small business (defined as a business with fewer than 25 full-time employees and a claim of less than \$1,000).

The debtor is not entitled to reimbursement unless (1) the movant's position violated Rule 9011 or (2) the movant's attorney did not comply with the requirements of subsection (4)(c) (similar to Rule 9011) and brought the motion solely for the purpose of coercing the debtor to waive a right guaranteed by title 11. Section 707(b)(5).

VII. Means Test Application in Chapter 13⁸

Under the law predating BAPCPA, a chapter 13 plan may not be confirmed over the objection of the trustee or an unsecured creditor unless the debtor either pays unsecured creditors in full or devotes all “projected disposable income” to the plan for at least three years. Section 1325(b).

BAPCPA makes several important changes in the calculation of disposable income, importing for some purposes the provisions of 11 U.S.C. § 707(b)(2).

The starting point is to determine the debtor’s income. The debtor’s income is the current monthly income (defined at § 101(10A)) reduced by any child support, foster care, or dependent disabled child receipts. Section 1325(b)(2).

The next step is to determine the expenses that may be deducted to arrive at disposable income. That determination is made by comparing the debtor’s annualized current monthly income to the median income for an Alabama household of the same size.

If the debtor’s annualized current monthly income is larger than the State’s median, allowable expenses are determined as provided by the means test under § 707(b)(2). Conversely, if the debtor’s annualized current monthly income is smaller than the State’s median, then allowable expenses are those that are reasonably necessary for the maintenance and support of the debtor and the debtor’s dependents without reference to § 707(b)(2)

⁸ None of the § 707(b) provisions are incorporated into chapter 12. Hence, the amount that a chapter 12 debtor must pay to unsecured creditors remains unchanged by the new law.

allowances and calculations.

Finally, the BAPCPA introduces a new term in § 1325(b)(1)(B): “applicable commitment period.” If the annualized current monthly income of the debtor and the debtor’s spouse is above the State median, the debtor must pay all disposable income into the plan for a five-year period. However, if the annualized current monthly income of the debtor and the debtor’s spouse is below the State median, the debtor must pay all disposable income into the plan for only three years.

VIII. Means Test Application in Chapter 11

The BAPCPA incorporates the definition of disposable income contained in 11 U.S.C. § 1325(b)(2) (which in turn incorporates provisions of § 707(b)(2)). A chapter 11 plan of an individual debtor may not be confirmed over the objection of an unsecured creditor unless the debtor either pays the unsecured creditor in full or devotes all of his disposable income to fund the plan for at least 5 years. Section 1129 (a)(15).

TABLE OF CONTENTS

I. Section 707 History and Application	2
II. Congressional Intent Under the BAPCPA	4
III. The Basic Means Test Formula	5
A. Current Monthly Income	7
B. Allowed Monthly Expenses	8
1. The National Standard	8
2. The Local Standard	9
3. Other Necessary Expenses	10
4. Allowable Expenses Beyond Other Necessary Expenses	11
5. Deductions for Secured and Priority Debt Payments	12
IV. Dismissal for Abuse Other than through the Means Test	13
V. Liability of Debtor's Counsel	14
VI. Liability of Creditor or Creditor's Counsel	14
VII. Means Test Application in Chapter 13	15
VIII. Means Test Application in Chapter 11	16